No. 10379

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

NAT ROGAN, Collector of Internal Revenue for the Sixth Internal Revenue Collection District of California,

Appellant,

vs.

THE STARR PIANO COMPANY, Pacific Division, a corporation,

Appellee.

Upon Appeal from the District Court of the United States for the Southern District of California.

BRIEF FOR APPELLEE.

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Upon Appeal from the District Court of the United States for the Southern District of California.

BRIEF FOR APPELLEE.

Opinion Below.

The opinion of the District Court [R. 41-42] is unreported.

Jurisdiction.

This is an appeal from the judgment by the United States District Court, Southern District of California, rendered October 3, 1942, in favor of the plaintiff for $73,557.08 together with interest, income and profits

taxes for the year 1934 [R. 45-46]. Appellee's complaint sought recovery from appellant of corporation income and excess profits taxes and interest for 1934 assessed and paid to him by appellee in the sum of $73,557.08, together with interest from date of payment [R. 2-9]. Appellee filed its claim for refund of income and excess profits taxes with the Commissioner of Internal Revenue on August 18, 1939 and said claim for refund was disallowed by the Commissioner of Internal Revenue on September 20, 1940 [R. 8, 18]. Appellee filed suit for recovery on March 20, 1941 [R. 2-15]. Jurisdiction was vested in the United States District Court under Section 24, fifth of the Judicial Code. Notice of appeal was filed December 1, 1942 [R. 46, 47]. Jurisdiction is conferred upon this Court by Section 128(a) of the Judicial Code, as amended.

Questions Presented.

Two questions are involved in this appeal.

1. Did appellee realize a taxable gain by reason of the fact that during the year 1934, pursuant to an agreement of merger and consolidation under the California statutes, appellee and its wholly owned subsidiary, Gennett Realty Company, both California corporations, were merged and consolidated?

2. Should the corporate entity of the Gennett Realty Company be disregarded?

Statutes and Regulations Involved.

The statutes and regulations involved are set forth in the Appendix, *infra,* pages 1 to 7.

Statement.

The relevant facts in the case may be briefly summarized as follows:

Appellee is a corporation duly organized and existing under and by virtue of the laws of the State of California with principal place of business located in the County of Los Angeles [R. 2]. During the months of February and March, 1921, appellee entered into two ninety-nine year leases covering property situated in the City of Los Angeles [R. 20]. During the month of May, 1922, appellee caused the Gennett Realty Company, a corporation, to be incorporated under the laws of the State of California [R. 20]. The Gennett Realty Company was caused to be organized by appellee for the purpose of holding legal title to the two leases it had acquired in February and March, 1921 [R. 20-21]. On July 17, 1922, appellee transferred all its right, title and interest in the two leases aforesaid to Gennett Realty Company in exchange for all the capital stock of the latter [R. 21]. At all times during the existence of Gennett Realty Company appellee owned all its issued and outstanding capital stock [R. 21]. On August 1, 1922, the Gennett Realty Company as lessor, and appellee, as lessee, entered into a sublease of the property which appellee had transferred to Gennett Realty Company. The lease was for a term of 15 years [R. 21]. During the year 1922 Gennett Realty Company issued its bonds in the amount of $200,000.00 for the purpose of raising funds to construct a building on one of the leases transferred to it by appellee. The funds were actually raised and a building constructed [R. 21]. On July 1, 1923, Gennett Realty Company and appellee as lessors, entered into a sublease for a period

of 25 years of the property on which the building aforesaid was constructed [R. 21]. On May 1, 1924, the sublease was extended to April 30, 1984. On May 1, 1924, Gennett Realty Company and appellee, as lessors, entered into a sublease of the other property which appellee had originally transferred to Gennett Realty Company, the term of the sublease being for a period of 60 years.

During the existence as a corporation of the Gennett Realty Company its directors and officers were persons employed by appellee and who were actively engaged in activities carried on by appellee. Gennett Realty Company had no office separate and apart from appellee. Gennett Realty Company had no assets except the leases transferred to it by appellee. Gennett Realty Company did not have a bank account. Gennett Realty Company had no employees other than its officers and directors who were employees of appellee. All bookkeeping of the Gennett Realty Company was done by an employee of appellee. All indebtedness of Gennett Realty Company was paid by check of the appellee. All rentals due Gennett Realty Company were collected by a Los Angeles bank as trustee [R. 22-23].

For the years 1922, 1923 and 1924 appellee and Gennett Realty Company filed separate corporate income tax returns. At all times during its existence, with the exception of the year 1934, Gennett Realty Company and appellee filed consolidated corporate income and franchise tax returns. During the year 1934 appellee transferred certain accounts to Gennett Realty Company to be collected in the name of Gennett Realty Company. Part of said accounts were collected in the name of Gennett Realty Company. The uncollected accounts were trans-

ferred back to appellee. Gennett Realty Company carried on no activities except as enumerated in this statement [R. 23].

During July and August, 1934 the Gennett Realty Company merged into appellee. The merger was made in compliance with the provisions of Division First, Part IV, Title 1, Chapter XIII of the Civil Code of California.

The merger agreement was approved by the Board of Directors of Gennett Realty Company, the shareholders of Gennett Realty Company, the Board of Directors of appellee and the shareholders of appellee on July 31, 1934. A certificate relating to the merger agreement was filed with the Secretary of State of the State of California on August 1, 1934 and the same certificate was filed with the County Clerk of the County of Los Angeles, in which county appellee had its principal place of business on August 10, 1934. A like certificate on the same dates was filed with the same officials on behalf of Gennett Realty Company [R. 23, 24, 25].

Pursuant to the statutory merger all the assets of Gennett Realty Company became vested in appellee and all liabilites of Gennett Realty Company were assumed by appellee. All shares of stock of Gennett Realty Company, by virtue of the merger agreement, were surrendered to and cancelled by appellee [R. 29-40].

The Commissioner of Internal Revenue determined that appellee derived a taxable gain incident to the receipt by appellee of property of Gennett Realty Company as a result of the statutory merger.

Summary of Argument.

The appellee realized no taxable gain by reason of the receipt of the assets of its subsidiary by operation of law pursuant to a statutory merger or consolidation. In the case of a merger or consolidation of independent companies the acquiring corporation realizes no income or gain through acquisition of assets, not because of any express statutory provision of Section 112, but because there is no gross income under Section 22(a) to a corporation from the acquisition of the capital funds with which it carries on business. A newly organized corporation realizes no income by acquiring assets for newly issued stock and a combination of assets and franchises of two corporations united and continuing by merger or consolidation cannot give rise to income to the continuing corporation.

Section 113(a)(7) of the Revenue Act of 1934, prescribing that the "basis" for assets acquired in connection with a reorganization, where an interest or control of 50% or more continues in the same persons, is the same as the basis for such assets in the hands of the transferor, adjusted only for loss or gain recognized to the transferor.

The underlying assumption of both the basis provisions and the non-recognition provisions is that the acquiring corporation receiving property in a statutory merger or consolidation realizes no gain thereby.

The law of the case is not changed by reason of the fact that the company which is merged was a subsidiary of the continuing company.

The same transfer of assets cannot constitute both a transfer by operation of law pursuant to a statutory merger or consolidation and a distribution in liquidation of the subsidiary. This is so because merger or consolidation is continuance of corporate life and liquidation is winding up or corporate death.

The fact that appellee made no formal exchange of stock for stock of the subsidiary does not change the nature of the transaction or give rise to taxable income. Appellee in legal effect exchanged stock as to which Section 112(b)(3) specifically provides that no gain shall be recognized. Under the merger agreement it was provided that no additional stock of appellee would be issued. The issuance of additional stock would have been a useless act as the stock of the subsidiary was owned 100 per cent by appellee and if stock was to be issued appellee would have to issue its own stock to itself.

The appellee in its capacity as a continuing corporation received the assets of the merged subsidiary by operation of law and in its capacity as a stockholder of the merged subsidiary either received stock in exchange for its stock or received nothing therefor.

The District Court, based upon substantial evidence, held that the corporate entity of the subsidiary should be ignored and this should not be disturbed by this Court.

The subsidiary, Gennett Realty Company, was a mere agent or instrumentality of appellee and by reason of the peculiar facts obtaining should be ignored and disregarded for tax purposes.

ARGUMENT.

I.

Appellee Realized No Taxable Gain by Reason of the Receipt of the Assets of the Subsidiary Pursuant to a Statutory Merger or Consolidation.

The fundamental question in this case is whether appellee acquired the assets of its subsidiary by operation of law as the continuing corporation resulting from a "statutory merger or consolidation" or whether it received such assets as a distribution in liquidation of the subsidiary to be treated as received in exchange for its stock in the subsidiary. It is the contention of appellee that the assets were received by operation of law in a statutory merger or consolidation and not as a distribution in liquidation and that such acquisition did not result in the receipt of income.

(a) Appellee Received the Assets of Its Subsidiary by Operation of Law, Pursuant to a Statutory Merger or Consolidation.

The record contains the text of the agreement of merger and consolidation [R. 27-40]. The stipulation of facts sets forth that the agreements were carried out in accordance with their terms [R. 23-25].

The agreements recite that appellee is the sole stockholder of the subsidiary and that the parent and subsidiary have agreed to reorganize and to carry out such reorganization by means of a statutory merger or consolidation in accordance with the provisions of the Civil Code of the State of California and that it is deemed to the best interests of each to merge the Gennett Realty Company into appellee and that appellee after such merger

shall be and become the surviving corporation as provided by the provisions of the Civil Code of the State of California.

Section 361 of the Civil Code is set forth in the Appendix and by recourse thereto there can be no question but that appellee acquired the assets by operation of law pursuant to Section 361, *supra* and that the agreement was made in conformity therewith.

(b) A Corporation Realizes No Income or Gain by Acquiring the Assets of a Subsidiary by Operation of Law Pursuant to a Statutory Merger or Consolidation. This Does Not Depend on Any Express Statutory Provision for Non-recognition of Gain.

Appellant contends that the receipt of assets by the continuing corporation, pursuant to a statutory merger or consolidation, gave rise to taxable gain unless some provision of Section 112 could be found which specifically provides that no gain should be recognized from such receipt of property. It is submitted that such contention is erroneous, for on general principles such an acquisition does not give rise to taxable gain. The reason that Section 112 contains no express provision to that effect is not that Congress intended that all such acquisitions should be taxed but that Congress recognized the established principle that where a corporation makes such a capital acquisition it realizes no taxable gain.

Nowhere in Section 112, or elsewhere in the statute, is there provision that either a newly organized corporation, a new consolidated corporation or a continuing merged corporation is not taxable upon receipt of the assets acquired upon its organization or reorganization. Appel-

lant's reasoning on this point would lead to the conclusion that any newly organized corporation, new consolidated corporation or continuing merged corporation receiving assets in connection with its organization or reorganization would be taxable thereon because unable to point to any applicable non-recognition provision of Section 112.

It is clear that a newly organized corporation does not realize income by acquiring assets or money for newly issued stock or as a paid-in surplus. The corporation is merely organized or created; it has not realized a gain; it has merely received capital funds from its stockholders. See Articles 22(a)-15 and 22(a)-16, Regulations 86 (1934) "Contributions to capital are, of course, not taxable as corporate income." *Carroll-McCreary Co., Inc. v. Commissioner,* 124 Fed. (2d) 303 (2nd C. C. A. 1941).

By the same reasoning it follows that the combination of the assets and franchises of two corporations uniting for continuance cannot give rise to income to the continuing company, whether such company is a new corporation resulting from a consolidation or the continuing company in a merger. There is merely a joinder of the capital funds possessed by the two corporations in a union of the two corporations, all the franchises, rights and liabilities of which continue in the resulting corporation by operation of law.

No statutory provision is necessary to relieve such accession to corporate assets of income tax and this for the reason there is no gain or income within the meaning of Section 22(a) defining income. The corporation is not making a gain through sale, exchange or other disposition of assets. It is merely receiving capital funds with which to carry on business. There has never been any claim that

upon the merger or consolidation of previously independent corporations, the corporation acquiring assets realized any gain or income as the result of such acquisition.

That Congress recognized that a corporation realizes no gain by acquiring the assets of another corporation in connection with a reorganization is demonstrated by Section 113(a)(7) of the Revenue Act of 1934, providing for the "basis" for tax purposes of assets so acquired. Section 113(a)(7) provides:

> "If the property was acquired after December 31, 1917, by a corporation in connection with a reorganization, and immediately after the transfer an interest or control in such property of 50 per centum or more remained in the same persons or any of them, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. * * *"

Obviously, if the value of the assets received by the acquiring company in a reorganization were used to measure income or gain to it, it should in all fairness be entitled to use such value as the "basis" for such assets for the future, but the statute does not contemplate such a possibility. The statute expressly provides for an increase of the prior basis of the assets by the amount of any gain recognized to the *transferor,* but makes no provision whatever for any adjustment of basis on account of gain to the *transferee.* The reason for this is that Congress recognized that although the *transferor* might in some cases be taxed on a gain based on what it received for the transfer of assets in connection wtih a reorganization, the ac-

quiring company could not be regarded as receiving income or realizing gain by the mere acquisition of assets in this way.

The underlying assumption of both the "basis" provision and the non-recognition provisions is that the company acquiring the assets of other corporations in connection with a reorganization will receive them in such manner as not to give rise to taxable income. For this reason, it is unnecessary to provide in Section 113(a)(7) for any adjustment of basis of assets on account of such a transaction and equally unnecessary to provide in Section 112 for the non-recognition of gain.

It follows that the acquisition by the continuing company of the assets of the merged or constituent companies pursuant to a statutory merger or consolidation does not give rise to any taxable gain to the continuing corporation.

(c) The Fact That the Merged Company Was a Subsidiary of the Company Continuing After the Merger Does Not Change the Nature or Tax Effect of the Acquisition of the Assets of the Subsidiary.

The fact that the company which is merged was a subsidiary of the continuing company prior to the merger does not change the nature or legal consequences incident to the acquisition of the merged company's assets. There can be no question concerning this where there is a consolidation of two companies. The result cannot be different between consolidations and mergers. California statute requires the same procedure incident to mergers and consolidations and this whether the merged company is a subsidiary or not. It is the position of appellee that for tax purposes the effect of the acquisition of the subsidiary assets through

a merger or consolidation is exactly the same as that of the acquisiton of the assets of a wholly independent company in the same manner. In neither case does any gain to the continuing company result or accrue from such acquisition.

Section 113(a)(7) of the Revenue Act of 1934 demonstrates that this is the correct view. Under that section the appellee in this case is required to use as the basis of the subsidiary assets the same basis as such assets had in the hands of the subsidiary because it acquired such assets in connection with a reorganization, 100% control continued and no gain was recognized to the subsidiary, which received nothing for its assets.

The courts, in connection with cases involving the amortization of bond discount have held that where a subsidiary is merged into a parent corporation the parent does not acquire the assets of the subsidiary by purchase or by way of liquidation, but acquires such assets as a successor by operation of law pursuant to a merger or consolidation without break in the continuing corporate ownership of such assets.

In *Helvering v. Metropolitan Edison Co.* and *Helvering v. Pennsylvania Water & Power Co.,* 306 U. S. 522 (1939), the Supreme Court held that upon a statutory merger of a subsidiary into a parent corporation the continuing parent corporation was entitled to deduct unamortized discount and expense with respect to bonds which had been issued by the subsidiary. In that case, the Government conceded that upon a true merger or consolidation the successor stepped into the shoes of the merged subsidiary, but contended that the transactions under review were not true statutory mergers but were mere sales

by one corporation of all its assets to another which assumed the liabilities of the former. The Court held the transactions to be mergers under Pennsylvania law and not sales of assets and said at page 529:

> "We are of opinion that a transfer without valuable consideration, with the intent that the transferor shall, as the statute provides, cease to exist, made in accordance with the statute, has all the elements of a merger and comes within the principle that the corporate personality of the transferor is drowned in that of the transferee. It results that the continuing corporation may deduct unamortized bond discount and expense in respect of the obligations of the transferring affiliate."

It should be emphasized that these cases were mergers of subsidiaries into continuing parents.

The Circuit Court of Appeals for the Second Circuit in *New York Cent. R. Co. v. Commissioner,* 79 Fed. (2d) 247, cert. den. 296 U. S. 653, held that the merged company stepped into the place of the constituent corporations and said at page 249:

> "The consolidated corporation does not succeed to the rights and liabilities of the constituent companies as a purchaser but as a successor by operation of law. See Cortland Specialty Co. v. Commissioner, 60 F. (2d) 937, 939 (C. C. A. 2); Commissioner v. Oswego Falls Corp. (C. C. A.) 71 F. (2d) 673, 676 (C. C. A. 2). The assets of the consolidated corporation have the same cost basis as they had when held by the old companies, and are subject to the lien of the bond issues. Hence the consolidated corporation will suffer a loss when it pays the bonds at par, and the regulations as to spreading this loss over the life of

> the bonds should apply. They do not in terms confine discount deductions to the issuing corporation, and should not be construed to do so. If the new corporation cannot take the deduction, no one can, for the old companies sustained no loss when the consolidation was effected."

Later the Court, at page 250, said:

> "The principles above discussed as applicable in case of consolidation are equally applicable to merger."

In *American Gas & Electric Co. v. Commissioner,* 85 Fed. (2d) 527, the Circuit Court of Appeals for the Second Circuit establishes the difference between the income tax effect of a successorship by operation of law pursuant to a statutory merger or consolidation where the corporate identities are held to continue and other transactions, even though non-taxable, where the corporate identity is not preserved. The Court stated at page 530:

> "The situation in New York Central R. Co. v. Commissioner, 79 F. (2d) 247 (C. C. A. 2) and Western Maryland R. Co. v. Commissioner, 33 F. (2d) 695 (C. C. A. 4), was different. In each of those cases there was a consolidation of the corporations, and amortization was allowed for the life of the bonds on the ground that the consolidated corporation succeeded to the rights and liabilities of the constituent companies, not as a purchaser, but by operation of law. A merger will in general preserve corporate identity and continue the obligations against a successor company, which is treated as identical with the former obligor. Cortland Specialty Co. v. Commissioner, 60 F. (2d) 937, 939 (C. C. A. 2)."

The Circuit Court of Appeals for the Second Circuit in *General Gas & Electric Corporation v. Commissioner,* 98 Fed. (2d) 561, reversed 306 U. S. 530, wherein the Court stated at page 563:

> "It is conceded that unamortized discount and expenses incurred in connection with the issue and sale of bonds are deductions available to the issuing corporation when it pays them off prior to maturity. See Helvering v. Union Pacific R. Co., 293 U. S. 282, 55 S. Ct. 165, 79 L. Ed. 363; Great Western Power Co. v. Commissioner, 297 U S. 543, 56 S. Ct. 576, 80 L. Ed. 853. It is also not disputed that such items are allowable deductions to a successor corporation which through merger or consolidation has carried forward the corporate identity of the issuing corporation and has succeeded by operation of law to its rights and liabilities. American Gas & Elec. Co. v. Commissioner, 2 Cir., 85 F. 2d 527; New York Central R. Co. v. Commissioner, 2 Cir., 79 F. 2d 247, certiorari denied 296 U. S. 653, 56 S. Ct. 370, 80 L. Ed. 465; Western Maryland Ry. Co. v. Commissioner, 4 Cir., 33 F. 2d 695. When, however, the successor corporation acquires the assets of the issuing corporation by purchase, rather than by a consolidation or merger, such deductions are not available. American Gas & Elec. Co. v. Commissioner, 2 Cir., 85 F. 2d 527; American Gas & Elec. Co. v. United States, 17 F. Supp. 151, Ct. Cl.; Turner-Farber-Love Co. v. Helvering, 62 App. D. C. 369, 68 F. 2d 416. Whether the transactions at bar are to be classed as mergers or as purchases is the issue in controversy."

The Supreme Court reversed the decision above because of its conclusion, evidenced by its opinion in *Helvering v. Metropolitan Edison Co.,* 306 U. S. 522, that there was an

assumption of liabilities by operation of law and hence held that the amortization deduction should be allowed in accordance with the legal principles stated.

It is clear that if the acquisition of the assets of a subsidiary pursuant to a statutory merger or consolidation were in fact or effect a distribution in liquidation of the subsidiary giving rise to taxable gain or deductible loss, the continuing company would be a purchaser and not a successor by operation of law and the decisions above would have been exactly opposite of what they were in the cases which involved subsidiaries.

The decisions turn on the legal effect under state law of the succession by one corporation to the assets, franchises and business of another corporation pursuant to a statutory merger or consolidation. *Helvering v. Metropolitan Edison Co.,* 306 U. S. 522.

This Court has also held that in transactions constituting "reorganizations" under the Internal Revenue laws in which no gain or loss is recognized to the participating stockholders, the corporate identity continues so that the earnings and profits of the companies merged, consolidated or reorganized retain their status as earnings and profits in the hands of the continuing company. *U. S. v. Kauffmann,* 62 Fed. (2d) 1045. The Circuit Court of Appeals for the Second Circuit has held likewise in *Commissioner v. Sansome,* 60 Fed. (2d) 931.

In *Commissioner v. Kann,* 130 Fed. (2d) 797 (3rd C. C. A. 1942) a holding company was merged into its wholly owned subsidiary. The holding company owned nothing except the stock of the subsidiary and a small amount of cash. The Court held that the stockholders had realized

no taxable gain because they were exchanging stock of the parent for stock of the subsidiary pursuant to a statutory merger, a transaction falling within Section 112 (b) (3) of the Revenue Act of 1936, although the effect of the transaction on the stockholders was subsantially the same as if the parent company had made a direct distribution of the subsidiaries shares in liquidation. The Court followed its decision in *Commissioner v. Gilmore's Estate,* 130 Fed. (2d) 791 where a holding company owning a minority interest in the stock of an operating company, the balance of the stock of which was owned by the stockholders of the holding company, merged into the operating company. This decision was followed on the same facts by Circuit Court of Appeals for the 5th Circuit in *Commissioner v. Webster's Estate,* 131 Fed. (2d) 426.

From the above it follows that the appellee, despite the parent and subsidiary relationship, stands in exactly the same position with respect to the acquisition of the assets of the merged company as though there had been no such prior relationship. It is a successor to the business, franchises, assets and liabilities of Gennett Realty Company by operation of law and carries forward the identity of the merged subsidiary which is drowned in the continuing company. The appellee no more realized income through the acquisition of the assets of the merged company which was its subsidiary than it would have if the merged company had previously been a wholly independent company.

II.

Appellee Did Not Receive the Assets of Gennett Realty Company as a Distribution in Liquidation or in Exchange for the Shares of That Company.

The appellant takes the view that the transaction was both an acquisition of assets by operation of law pursuant to a statutory merger or consolidation *and* a receipt of such assets as amounts distributed in complete liquidation of Gennett Realty Company in exchange for its stock. We maintain this to be error and that the finding that the assets of Gennett Realty Company were transferred pursuant to a statutory merger or consolidation precludes any holding that the same transfer of assets was a distribution in liquidation of Gennett Realty Company.

(a) The Same Transfer of Assets Cannot Be Both a Transfer Pursuant to a True Statutory Merger or Consolidation and a Distribution in Liquidation of One of the Merging Companies. Merger or Consolidation Means Continued Corporate Life; Liquidation Means Winding Up, or Corporate Death, for the Liquidated Corporation.

We have heretofore shown the legal and tax consequences which flow from the receipt of assets by the continuing company pursuant to a statutory merger or consolidation. The assets, franchises and liabilities of the merged corporation and all its functions persist in modified corporate form as a part of the united corporation. The continuing company has not acquired the assets by purchase. The assets are acquired by it by operation of law for the purpose of continuing in corporate ownership in combined

or united form. Under Section 113(a)(7) it must take over the transferor's basis for the assets. The corporate business continues in modified corporate form and is not terminated and wound up. Under California statute all rights of creditors and all liens on the property of the former corporations are preserved unimpaired and the merged corporation is deemed to continue in existence in order to preserve the same and all obligations, restrictions and duties attach to the consolidated corporation. The corporate identities of the merged corporations continue as a joint or consolidated whole. No distinction is made between consolidations and mergers.

In sharp contrast with the continuance of corporate business and identity by merger or consolidation is the "liquidation" of a corporation. The theory and purpose of liquidation are well indicated by Article 112(b)(6)-1, Regulations 94 (1936), which provides:

> "A status of liquidation exists when the corporation ceases to be a going concern and its activities are merely for the purpose of *winding up* its affairs, *paying its debts* and *distributing* any remaining *balance* to its shareholders."

The definition of liquidation evidenced by the foregoing quotation is in exact accord with the effect of a liquidation under California law.

In *Wabash, St. Louis & Pacific Railway Company v. Ham,* 114 U. S. 587 (1885), earlier cases are cited and the principles stated as follows at page 595:

> "But upon the consolidation, under express authority of statute, of two or more solvent corporations, the business of the old corporations is not wound up,

nor their property sequestrated or distributed, but the very object of the consolidation, and of the statutes which permit it, is to continue the business of the old corporations. Whether the old corporations are dissolved into the new corporation, or are continued in existence under a new name and with new powers, and whether, in either case, the consolidated company takes the property of each of the old corporations charged with a lien for the payment of the debts of that corporation, depend upon the terms of the agreement of consolidation, and of the statutes under whose authority that consolidation is effected."

It is accordingly incorrect for appellant to contend that the acquisition of the assets of a subsidiary corporation by a statutory merger or consolidation involving the continued corporate life and activity of both the participating companies may also be a distribution of such assets by the subsidiary in liquidation is conclusively shown by the vital distinctions between the two types of transaction.

On the complete liquidation and dissolution of a corporation the business of the corporation ceases, its corporate powers terminate except for the winding up of its affairs, its trustees in liquidation wind up its affairs, pay its debts and divide whatever is left among its stockholders by payment or appropriate bills of sale or deeds or other instruments of transfer, and its corporate existence terminates. Upon a merger or consolidation the business of the merged corporation continues, the successor corporation is vested with its franchises, rights and powers, its affairs are not wound up, its creditors continue with identical unimpaired rights against the continuing company, its assets are not distributed to its stockholders but pass by operation of law to the continuing company without need for bills of sale,

deeds or other instruments of transfer, and its corporate existence continues, drowned in or combined with that of the continuing company.

On the liquidation of a corporation its creditors have no claim against the stockholders except as transferees of the corporation's assets. But where a corporation is merged or consolidated with another the rights of creditors of the merged or constituent companies continue, unchanged in character, against the continuing company.

On the liquidation of a company which has issued bonds at a discount the corporate stockholder who receives its assets on liquidation is not entitled to deduct bond discount with respect to such bonds because the acquiring corporation is regarded as a purchaser of the assets and the corporate existence of the liquidated company has terminated. But a successor to a subsidiary company by a merger or consolidation is entitled to continue to deduct the bond discount with respect to such bonds, it is not regarded as a purchaser of the assets and the corporate identity of the merged company is preserved and continued in the continuing corporation.

On the liquidation of a corporation its accumulated earnings and profits disappear as such and do not become earnings and profits of any corporate shareholder who receives its assets on liquidation. But where a corporation is merged or consolidated with another, its accumulated earnings and profits become earnings and profits of the continuing company available for distribution as dividends.

Under the Revenue Act of 1934 if the assets of a corporation are distributed in liquidation to its stockholders, the basis for such assets in their hands for the future is

the fair market value of the assets at date of distribution since they are required to treat such assets as received in exchange for their stock and to account for loss or gain on this basis. Upon a merger or consolidation the assets acquired by the continuing company "in connection with a reorganization" have the same basis as they had in the hands of the transferor subject to adjustment only for any gain or loss recognized to the transferor. Whether or not in such a case the transferee nevertheless realizes a gain is the question involved in this case.

These fundamental differences result because a merger or consolidation is as different from a liquidation as continued corporate life is from corporate death. In both theory and legal effect they are diametrically opposed. We submit that the appellant errs when he contends that although the assets of Gennett Realty Company passed to appellee by operation of law pursuant to a true statutory merger or consolidation, nevertheless such assets were distributed by Gennett Realty Company as distributions in complete liquidation and were received by appellee in exchange for its stock in Gennett Realty Company.

The decision of the Board of Tax Appeals in *Frelmort Realty Corporation,* 29 B. T. A. 181 (1933), is readily distinguishable because although the transaction took the form of a merger in that case, it was in fact a liquidation of the subsidiary. The business of the subsidiary and the venture on which it had embarked had been substantially completed. The parties desired to have the business wound up and an accounting for gains or losses. The Board said at page 189:

> "In the cases we have here, the evidence leaves no doubt that it was the intent of the parties interested

> in Brown-Rochester to wind up its business. It had been formed for a particular purpose—to hold title to certain real estate—and upon disposition of the property there was obviously no further need for the corporation to exist as a separate entity. Consequently those in control decided to liquidate, and upon distribution of its assets to petitioner the liquidation was an accomplished fact."

There was in the *Frelmort* case no true merger or consolidation, but merely a liquidation of a subsidiary company which was being wound up. In the present case the business of both corporations continued in combined corporate form.

Burnet v. Riggs Nat. Bank, 57 F. (2d) 980 (4th C. C. A., 1932), presents a similar situation. The Court held that the taxpayer was entitled to deduct a loss on the liquidation of a failing savings bank, the stock of which it had acquired a few months before to protect the general banking situation in the District of Columbia, even though the liquidation took place during a consolidated return period. The opinion states that the subsidiary was merged with the parent under an act of Congress but the facts show that liquidation of the failing bank was contemplated from the outset, and that the process of liquidation was under way before the transaction took place. The case was considered both by the Board of Tax Appeals and the Circuit Court of Appeals as a surrender by the taxpayer of the capital stock of its subsidiary in exchange for its assets. The question argued and decided was whether or not such a loss could be deducted where the liquidation took place during a consolidated-return period and the ef-

fect in determining the loss of the deduction in the consolidated return of the operating loss of the subsidiary.

These cases, properly viewed, are not, therefore, authority for the erroneous proposition that assets transferred pursuant to a true statutory merger of a subsidiary into a parent corporation may also be treated as distributions in liquidation of the subsidiary in exchange for its stock.

We do not contend that there may not be a liquidation of a corporation in connection with a transaction which may constitute a "reorganization" as defined in the Revenue Act. As pointed out in *Helvering v. Schoellkopf*, 100 F. (2d) 415 (1938), such a result may happen, particularly where the reorganization takes the form of a transfer by one corporation of all its assets to another in exchange for the distribution of stock of the transferee to the transferor's stockholders. Our contention is that the acquisition of assets by a successor corporation by operation of law pursuant to a true statutory merger or consolidation, cannot at the same time constitute a distribution in liquidation of the merged company falling within Section 115(c) even though the merged company was theretofore a subsidiary of the continuing company. In such a case the separate corporate existence of the merged company ceases, but it does not distribute its assets to its stockholders as distributions in liquidation; its assets pass to the successor corporation by operation of law, and its corporate identity continues drowned in and combined with that of the continuing company.

(b) The Fact That Appellee Could Have Acquired the Assets of Its Subsidiary in Liquidation Furnishes No Basis for Disregarding What Was Actually Done or For Treating the Merger as If It Were a Liquidation.

We are here dealing with a statutory merger. The question is whether the fact of the statutory merger can properly be disregarded merely because the merged company was a subsidiary of the continuing company; whether appellee may be taxed as if it had liquidated the subsidiary company because it might have done so, although it did not in fact do so.

Recent decisions of other Circuit Courts of Appeals dealing with cases of so-called "downstairs" mergers—merger of parent into subsidiary—clearly establish that the fact that the merger is between parent and subsidiary furnishes no basis for refusing to give effect to the tax consequences flowing from a statutory merger or consolidation, or for finding that one of the companies had in effect been liquidated because, in those cases, substantially the same result might have been accomplished by a liquidation.

In *Commissioner v. Gilmore's Estate*, 130 F. (2d) 791 (3rd C. C. A., 1942), the Court dealt with a case where a holding company, the assets of which were reduced to a minority interest of the stock of an operating company, merged with the operating company as the continuing company under the New Jersey statutes. The stockholders of the holding company already owned the majority of the stock of the operating company, and received the balance of such stock by the merger. The Court overruled arguments that the transaction was not a true statutory merger and held that the fact that the stockholders were in substantially the same position as though

there had been a liquidation of the parent company did not warrant treatment of the transaction as a liquidation of the holding company. The Court said at page 794:

> "In this case we have two corporations established long before the transaction in question, an operating company and a holding company. They desire to get rid of the holding company. The shareholders of the holding company were the majority owners of the operating company. By reason of the plan chosen they received the shares they had theretofore held indirectly through the holding company. There was no conversion into cash on withdrawal. Rather, the entire history of the two corporations reveals that the interests obtained through the merger were to be continuing and the surviving corporation kept on doing business with no change in management or personnel after the merger. We have, then, a genuine transaction in the sense that it was operating upon the situation of the companies as they stood. We have the continuity of uninterrupted corporate existence of the merged company and the interest of all prior owners therein, except, of course, of the dropping out of the holding company. Are there further requirements?
>
> "Argument for the Commissioner maintains that what has been done is still not enough. The result to be reached through this merger, it is said, could have been reached more directly by an out and out liquidation which, of course would have been taxable under Section 115(c). Granted that the elimination of the holding company as a subject for taxation was a legitimate business object, it does not follow that the method taken in getting rid of it is a tax-free method. We think this gets down to the proposition that if there are two ways of accomplishing a

> legitimate business result, one of which clearly creates a taxable transaction, one is equally subject to tax liability if he chooses the other unless there is an adequate business reason for the particular method used. We do not think this is the rule of the statute, the Regulations, nor, as we read them, the decisions."

The same Court reached the same result in the case of *Commissioner v. Bertha F. Kann,* 130 F. (2d) 797 (1942), where a parent company owning nothing except the entire capital stock of its subsidiary and a small amount of cash, merged with its subsidiary. The Circuit Court of Appeals for the Fifth Circuit in *Commissioner v. Webster's Estate*, 131 F. (2d) 426 (1942), followed the *Gilmore* case in the case of another stockholder involving the same reorganization.

With respect to these cases the following statement appears in *Woodruff v. Commissioner,* 131 F. (2d) 429, 430 (5th C. C. A., 1942):

> "It is true that the tax consequences of a transaction depend upon the substance of the transaction rather than the mechanics by which it is executed; but it is also true that, if a taxpayer has two legal methods by which he may obtain a desired result the method pursued is determinative for tax purposes without regard to the fact that different tax results might have attached if the alternative procedure had been followed."

We submit that, in the light of these cases, there is no basis for the contention of appellant in the present case

that because of the prior patent and subsidiary relationship the assets of Gennett Realty Company should be treated as having been received as a distribution in liquidation despite the finding that they were received pursuant to a statutory merger or consolidation by operation of law.

It equally follows that such assets were not received "in exchange for" the stock of Gennett Realty Company. The decisions establish that the assets were received by operation of law in a continuing transaction and irrespective of the stock ownership by the parent company. There was neither a distribution in liquidation of, nor an exchange of stock for, the assets so acquired, either in legal theory or in fact.

(c) The Fact That the Agreement of "Merger and Consolidation" Was Entered Into and Carried Out After Congress Had Made Specific Provision for Non-recognition of Gain Upon Liquidation of Subsidiaries, Establishes That the Parties Intended to Continue the Business and Identity of the Subsidiary Instead of Liquidating It.

Under Section 112(b) (6) of the Revenue Act of 1936, approved June 22, 1936, and effective for fiscal years beginning after December 31, 1935, it was provided as follows:

> "No gain or loss shall be recognized upon the receipt by a corporation of property distributed in complete liquidation of another corporation."

Certain conditions were imposed which could easily have been met in this case. This provision was a continuation

in somewhat changed form of an amendment made to the Revenue Act of 1934 by Section 110 of the Revenue Act of 1935 approved on August 30, 1935.

Appellant suggests that the fact that Congress had provided for non-recognition of gain upon a liquidation indicates that a merger of a subsidiary into a parent company prior to the effective date of that provision is necessarily taxed as a liquidation. Quite the contrary. Congress intended to promote simplification of corporate structures and liquidation of subsidiaries (80 Cong. Record, p. 8799) and in many states a subsidiary could not be merged into its parent, particularly where there were minority interests. The amendment shows that Congress desired that there be no taxable realization *even where a parent company actually liquidated its subsidiary.* This carries no implication that the consequences flowing from an acquisitition of assets in a statutory merger or consolidation under the prior law should be disregarded. It rather indicates the Congressional desire to extend to the actual liquidation of a subsidiary much the same tax consequences as resulted from a statutory merger or consolidation under the prior law from the standpoint of treating the assets transferred as continuing in corporate ownership under modified corporate form, without realization of gain or loss or change of basis (see Section 113(a)(15), Revenue Act of 1936).

III.

The Fact That Appellee Made No Formal Exchange of the Stock of Gennett Realty Company for Stock of the Continuing Company Does Not Change the Nature of the Transaction or Otherwise Give Rise to Taxable Income. Appellee Either in Legal Effect Received Stock of the Continuing Company in Exchange for Its Shares in Gennett Realty Company in a Non-recognition Exchange Under Section 112(b) (3), Or It Received Nothing for Such Shares.

The taxpayer contends that in legal effect under the California statutes it received stock in exchange for its shares in Gennett Realty Company and that pursuant to Section 112(b) (3) such exchange gave rise to no gain recognized for tax purposes. The fact that the formality of issuing the stock certificates was dispensed with does not convert what would otherwise have been an exchange into a distribution in liquidation but at most means that the taxpayer received nothing for such shares.

If the agreement of consolidation and merger in this case had provided that the appellee as the continuing company should issue shares of its stock to the stockholders of Gennett Realty Company, the exchange would fall squarely within Section 112(b) (3) and no gain would be recognized. Section 112(b)(3) provides:

> "No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization."

Every requirement of this provision would be met as the transaction was admittedly a "reorganization," both corporations obviously were parties (Section 112(g) (2) and the exchange of stock for stock would have been made pursuant to the plan.

Where this formality has been complied with in reorganization cases, even where there was no statutory merger or consolidation, section 112(b)(3) has been held applicable. In *Helvering v. Winston Bros. Co.*, 76 F. (2d) 381 (8th C. C. A., 1935), Winston Bros. Co. owned 78% of the common stock, but none of the preferred stock, of Winston-Dear Company and pursuant to a plan acquired all the assets and assumed all the liabilities of Winston-Dear Company in exchange for 1,803 common shares and 1,116 preferred shares of its own stock. The preferred shares were distributed to the preferred stockholders of Winston-Dear Company share for share and the common shares were distributed pro rata to common stockholders. As one of the common stockholders, Winston Bros. Co. received back 1,232 shares of its own common stock, which it immediately retired. The Court held that Winston Bros. Co. did not receive any of the assets of Winston-Dear Company as a distribution in liquidation, but that like the other common stockholders it made an exchange of common stock of Winston-Dear Company for its own common stock pursuant to a plan of reorganization and that therefore no gain was to be recognized pursuant to Section 112(b) (3), Revenue Act of 1928.

If it is borne in mind that essentially there was in the present case merely a readjustment of corporate form with continuing interests in the same persons, that the transac-

tion would fall squarely within Section 112(b) (3), and that even if the transaction had been a liquidation of the subsidiary company, which it was not, congress in Section 110 of the Revenue Act of 1935 and Section 112(b) (6) of the Revenue Act of 1936 (applicable to the taxable years beginning on and after January 1, 1936) provided that no gain should be recognized in such a case, there can be little doubt that the courts would hold that Section 112(b) (3) was applicable if the formality of issuing additional shares to appellee in place of shares of Gennett Realty Company had taken place (*Commissioner v. Gilmore's Estate,* 130 F. (2d) 791 (2nd C. C. A., 1942); *Helvering v. Schoellkopf,* 100 F. (2d) 415 (2nd C. C. A., 1938)).

Appellee maintains that the substitutial effect of the transaction was exactly the same as if this formality had been complied with. The California statutes (Section 361) requires that the agreement of merger or consolidation shall prescribe

> "the manner and basis of converting the shares of the constituent corporations into the shares of the consolidated or surviving corporation." (See Appendix, p. 3.)

This requirement was complied with in the agreement by providing that the stock of Gennett Realty Company should be cancelled, the issuance of stock by the appellee in lieu thereof being dispensed with since the appellee was the only stockholder of the merged company. The stock of Gennett Realty Company obviously had value, the appellee clearly had the right to refuse to agree to the merger or consolidation without getting equivalent value in stock of the continuing company in lieu of its shares

of Gennett Realty Company and obviously consented that the issuance of this stock to it should be dispensed with because the result would merely be that it would hold some of its own shares of stock.

Appellant leans heavily upon the decision of the United States Board of Tax Appeals in the case of *Gutbro Holding Co. v. Commissioner,* 47 B. T. A. 374. For the reasons hereinbefore set forth we think the Board fell into error in the decision rendered and desire to state that the case is now on appeal to the Circuit Court of Appeals for the Second Circuit and set for argument on May 18, 1943.

Even if it should be thought that the omission of the mechanical step of exchanging stock for stock is a technicality which has significance, it is difficult to see how the agreement of the appellee not to receive this stock to which it was entitled increases its income or creates a gain or changes the nature of the transaction. The appellee, as *stockholder* of Gennett Realty Company, had no right to receive the assets of that company because it was not liquidated. Appellee's right to the assets arose solely because it was the continuing company in a statutory merger or consolidation. Appellee's sole right as holder of the stock of Gennett Realty Company was to receive stock in the continuing company. As shown above, if it had exercised this right and received this stock in exchange for the stock of Gennett Realty Company, no taxable gain would have resulted. Its receipt of property as stockholder, *i. e.,* what it received in exchange for its stock in Gennett Realty Company, certainly cannot be increased by its waiver of the right to receive stock in

itself as the continuing company. Since the taxpayer would realize no taxable gain on the receipt of stock itself, *a fortiori,* it realized no taxable gain by receiving nothing.

If appellee had taken the formal step of receiving shares of its own stock in exchange for the stock of Gennett Realty Company and then cancelling such stock, which in substance was what was done—that transaction gave rise to no taxable gain. What actually was done, as a matter of mechanics, was that this formal step was dispensed with, and the stock of Gennett Realty Company was merely cancelled, so that appellee received nothing for such stock.

In this merger and consolidation the appellee acted in two capacities. In the first place it was the continuing corporation in a statutory merger or consolidation and, as such, the assets of the merged company were combined with its assets by operation of law. As shown, the receipt of assets in this manner gives rise to no income, whether the transaction was technically a merger or a consolidation. In the second place, the appellee had a right to receive stock of the continuing company in place of its stock in the merged company. If it had received such stock, no taxable gain would have resulted because of Section 112(b)(3). Its taxable income certainly can be no greater merely because it did not go through the mechanical formality of receiving such stock and then cancelling it. In these capacities, whether considered separately or together, the petitioner realized no taxable income by reason of the receipt of the assets of Gennett Realty Company.

IV.

The Corporate Entity of the Gennett Realty Company Should be Disregarded.

The lower Court because of the peculiar facts here involved held that the corporate entity of the Gennett Realty Company should be disregarded.

The only function of Gennett Realty Company was to hold legal title to two long-term leases which had been transferred to it by its sole stockholder, the appellee. The members of the Board of Directors of and its officers were persons employed by appellee and were actively engaged in the activities carried on by appellee. The Gennett Realty Company had no assets except the leases aforesaid. It did not have a bank account. It had no employees except its Officers and Directors. An employee of appellee did all the bookkeeping for Gennett Realty Company. All its debts were paid by the check of appellee. It had no office separate and apart from appellee. All rentals due under the leases transferred by appellee to Gennett Realty Company were collected by a trustee and the latter paid all interest due on its bonds and taxes due on the leased properties. In the sublease of properties transferred to Gennett Realty Company by appellee such leases were entered into by and on behalf of Gennett Realty Company and appellee as lessors.

It was by reason of these peculiar facts that the Court below held that appellee and Gennett Realty Company were so closely related in control, management and operation that the corporate entity of the wholly owned subsidiary should be disregarded.

The courts have frequently held that where a subsidiary corporation carries on no separate business and

does not operate independently of its parent, the two corporations should be considered as one. Whether or not a subsidiary should be treated as a separate entity from its parent depends upon the particular facts in each case and it is submitted that the facts in the case at bar are such as to justify if not require the disregard of the Gennett Realty Company as a separate entity.

> *Southern Pacific Company v. Lowe,* 247 U. S. 330;
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> *Inland Development Company v. Commissioner* (C. C. A. 10), 120 Fed. (2d) 986.

In *Inland Development Company v. Commissioner, supra,* the parent corporation caused certain oil leases to be transferred to subsidiary corporations of which the parent owned all the stock. The subsidiary corporations executed contracts for the drilling of oil wells on the leases so transferred. The costs of drilling and operation of the oil wells of the subsidiaries were paid by the parent and charged to the account of the subsidiaries. The income from the operations of the wells was received by the parent and credited to the account of the subsidiaries. In the year 1934, the Directors of one of the subsidiaries declared a dividend in the amount of $53,125.00. An entry was made on the books of the subsidiary charging the earned surplus account and crediting the account of the parent with the amount of the dividend.

If the dividend of $53,125.00 was income as such to the parent the latter would be classified as a personal holding company and subject to the surtax on the undistributed income. If the separate entity of the subsidiary was not recognized the amount received would not be classified as dividends and accordingly the parent

would not be classified as a personal holding company. The Court held that the separate entity of the subsidiary should be ignored, stating as follows:

> "This taxpayer owned all of the stock of the several subsidiaries. Each subsidiary owned no assets whatever except the one lease transferred to it in the manner indicated. The subsidiary in each instance executed the contract under which the well was drilled but the taxpayer paid all costs and expenses of drilling and operation, and it received directly all of the income arising from the sale of royalty oil. The subsidiaries had no employees, the work on the leasehold estates being done by employees of the taxpayer, no offices, no books, except those kept by employees of the taxpayer in its offices, and no bank account. They did not buy, acquire, manage, control, sell, receive, or pay out anything. The taxpayer did all of that, without voice on the part of the subsidiaries. It is difficult to understand the purpose or motive for causing the subsidiaries to be formed and in operating the business in the manner outlined. Escape from liability, or limitation of liability was not the purpose, as the taxpayer bore the entire financial responsibility; and the Commissioner does not contend that either savings in taxes or fraud of any kind was the incentive. But whatever the underlying reason may have been, it is clear that the subsidiaries were nothing more than voiceless departments or instrumentalities of the taxpayer. Substance is paramount over form in the application of income tax laws."

In the case of *United States v. Brager Building and Land Corp.* (C. C. A. 4), 124 F. (2d) 349, we find another case bearing closely upon the facts obtaining in

the case at bar. The Brager partnership prior to 1927 was engaged in carrying on a department store business in a store owned by the partnership. In 1927 the partnership sold the business to a third party. At the same time the partnership leased the store building owned by it to a third party for a period of twenty years. The store building was covered by a deed of trust under which certain amortization and interest payments were required to be made. The lease provided that the rental should be paid direct to the trustee and also provided for the payment of taxes and other fixed charges. In 1936 one of the two partners of the Brager partnership died. Under the terms of the partnership agreement the partnership did not terminate. The surviving partner on behalf of the partnership deeded the store property to a corporation in return for all the capital stock of said corporation for the purpose of providing an agency to hold legal title to the property and thus avoid certain complications. The partnership through its stock ownership retained complete control of the corporation. The corporation did not carry on any active business. The income involved was certain rentals paid by the tenant of the building direct to the trustee.

The Court held that the corporate entity should be ignored and that the income involved should be taxed to the partnership, stating as follows:

> "The purely nominal character of the Brager Building and Land Corporation is established beyond question by the undisputed facts set out above. It was a convenient agency chosen by the owners to hold the record title of their property and nothing more. It performed no other function, it engaged in no other activity, and was at all times completely sub-

ject to the dominion and control of the Brager partnership. The income from the property was in our opinion income of the partnership."

In *Helvering v. Security Savings & Commercial Bank*, 72 Fed. (2d) 874, we find a case on a state of facts much like the case at bar. There the Commissioner of Internal Revenue did not agree with the decision of the Board of Tax Appeals and the Circuit Court of Appeals for the Fourth Circuit reversed the decision of the Board. The Court held that a series of acts, corporate and otherwise, leading up to the purchase of the stock and business of the Central Savings Bank, did in effect constitute a single transaction, and where the sale of assets was made between two banks with identical officers and practically identical stockholders and the separate corporate entities became so merged that the line of demarcation was scarcely visible, then and in that event for tax purposes, where substance rather than form governs, the corporations should be treated as one in computing tax.

Appellant has cited a number of cases in which the courts have refused to disregard the separate entity of a subsidiary corporation. In each case, however, the subsidiary carried on activities or was availed of in such manner as to require that it be considered a separate entity. In *Texas Empire Pipe Line Company v. Commissionr*, 42 B. T. A. 368, affirmed 127 Fed. (2d) 220, the Court stated the subsidiary served two legitimate business purposes: (1) It acquired the power of eminent domain in Illinois, which power the parent corporation could not acquire; (2) It was availed of to reduce tax liability by the filing of a separate return for the year 1932. In *Burnett v. Riggs National Bank*, 57 Fed. (2d) 980, the

taxpayer acquired all of the stock of another bank and liquidated the subsidiary bank. In that case the subsidiary was a separate operating concern which carried on a business independent of that of parent. In that case the subsidiary was in no sense a mere department of the parent corporation. In *France v. Commissioner,* 88 Fed. (2d) 917, the facts were similar to the facts in *Burnett v. Riggs National Bank, supra.* In that case also the taxpayer acquired the stock of another subsidiary and later liquidated the subsidiary. In *Cerro de Pasco Copper Company v. United States,* 13 Fed. Supp. 633, there was also a mere liquidation of a wholly owned subsidiary corporation which had apparently carried on a business apart from its parent. In *Trenton Oil Company v. United States,* 41 Fed. Supp. 887, affirmed 122 F. (2d) 1023, the subsidiary filed separate income tax returns, maintained its corporate organization separate and distinct from the parent, had separate and distinct Board of Directors, officers and employees, held separate meetings, kept separate books and maintained a separate and distinct existence. Since in all the above cases the subsidiary corporation either operated a separate business or was availed of by the parent for business purposes, it is submitted that they do not support appellant's contention on the facts in the case at bar.

The stark facts are undisputed that the ownership of stock in the Gennett Realty Company by the appellee was not for the purpose of participating in the affairs of the Gennett Realty Company in a manner normal and usual with ordinary stockholders of a business corporation but was for the purpose of making the Gennett Realty Company a mere agent or instrumentality of the appellee. Following the statutory merger the appellee

was neither enriched nor impoverished. It had following the statutory merger just what it had before. The continuity of interest and control was completely preserved following the merger. This followed the pattern of what had been true from the inception of the Gennett Realty Company. The Gennett Realty Company had never in effect had or enjoyed a separate existence. It was a creature established by appellee and had only bare legal title to such assets as appellee chose to convey to it, its officers and directors were those of appellee, its place of business was that of appellee, the employees of appellee served as its employees, the appellee paid all its bills and absolutely controlled all business operations for profit or loss, the bank account and pocketbook of appellee was that of the subsidiary. In short it is respectfully submitted that for all practical purposes, the subsidiary was but a part of the appellee, acting merely as its agent and subject in all things to the proper direction and control of appellee, and by reason of the same the corporate entity of the subsidiary should be ignored.

If this case involved a situation where a loss was being claimed, the government would probably be the first to successfully contend that the corporate entity should be ignored in order that substance rather than form should prevail in taxation matters.

There is not the slightest hint or suggestion that tax avoidance or evasion occasioned the merger of the appellee with its subsidiary; neither was the government damaged from a tax standpoint. The appellee annually reports

whatever profit it derives from the leasing of the properties in question and should the appellee dispose of the leases in question, it will be required to report the resulting gain for tax purposes. To tax the appellee upon the gain which the government proposes is to indulge in the exaction of a tax before the happening of a taxable event and to levy a tax upon a fictitious gain.

The lower Court weighed the evidence adduced and its decision was based upon substantial evidence and was not clearly erroneous. The conditions under which the corporate entity may be disregarded or the corporation be regarded as the *alter ego* of the stockholders, necessarily varies according to the circumstances in each case, inasmuch as the doctrine is essentially an equitable one and for that reason is particularly within the province of the trial Court.

The Supreme Court of the State of California recently, it is submitted, in a tax case set forth the rule of law applicable in cases of the disregard of corporate entity when it said in the case of *H. A. S. Loan Service, Inc. v. McColgan,* 21 A. C. 551:

> "Plaintiff argues that in order to authorize the disregard of a corporate entity the evidence must be convincing and satisfactory and that a presumption of separate entity is present. However that may be, such rules are for the guidance of the trier of fact, and the rule on appeal is the same as in other cases; the conclusion of the trier of fact will not be disturbed if it is supported by substantial evidence.

The same principle is pertinent in analogous instances involving the proof of fraud. (See 12 Cal. Jur. 834.)"

The United States Supreme Court has granted certiorari in two cases, *Commissioner v. Moline Properties, Inc.*, 131 Fed. (2d) 388 (5th Circuit), and *Interstate Transit Lines v. Commissioner,* 130 Fed. (2d) 136 (8th Circuit), which have been argued wherein was involved this general question and the decision of the Court will without doubt greatly clarify the question at issue.

Conclusion.

We respectfully urge that the judgment of the District Court be affirmed.

Respectfully submitted,

CLAUDE I. PARKER,

JOHN B. MILLIKEN,

Counsel for Appellee.

APPENDIX.

The Statutes Involved.

REVENUE ACT OF 1934

SEC. 111. DEFINITION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) COMPUTATION OF GAIN OR LOSS.—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113(b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) AMOUNT REALIZED.—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

(c) RECOGNITION OF GAIN OR LOSS.—In the case of a sale or exchange. the extent to which the gain or loss determined under this section shall be recognized for the purposes of this title, shall be determined under the provisions of section 112.

* * * * * * * * *

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) GENERAL RULE.—Upon the sale or exchange of property the entire amount of the gain or loss determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) EXCHANGES SOLELY IN KIND.—

* * * * * * * * *

(3) Stock for Stock on Reorganization.—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(4) Same—Gain of Corporation.—No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

(g) Definition of Reorganization.—As used in this section and section 113—

(1) The term "reorganization" means (A) a statutory merger or consolidation, * * *

Sec. 113. Adjusted Basis for Determining Gain or Loss.

(a) Basis (Unadjusted) of Property.—The basis of property shall be the cost of such property; except that—

(7) Transfers to Corporation Where Control of Property Remains in Same Persons.—If the property was acquired after December 31, 1917, by a corporation in connection with a reorganization and immediately after the transfer an interest or control in such property of 50 per centum or more remained in the same persons or any of them, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. * * *

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

* * * * * * * * *

(c) DISTRIBUTIONS IN LIQUIDATION.—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. * * *

DIVISION FIRST, PART IV, TITLE 1, CHAPTER XIII, Section 361, of the CIVIL CODE OF CALIFORNIA

"361. MERGER AND CONSOLIDATION OF CORPORATIONS: (1) APPROVAL BY BOARD. STATEMENTS IN AGREEMENT. (2) SIGNATURES. (3) APPROVAL BY SHAREHOLDERS. CERTIFICATE OF CONTENTS. (4) AMENDMENTS TO AGREEMENT. (5) FILING OF AGREEMENT. (6) SURPLUS. (7) SEPARATE EXISTENCE. CREDITORS' RIGHTS.

Any two or more corporations may be (a) merged into one of such constituent corporations, which is herein designated as 'the surviving corporation,' or (b) consolidated into a new corporation, which is herein designated as 'the consolidated corporation,' as follows:

(1) The board of directors of each corporation by resolution shall approve an agreement which shall set forth the terms and conditions of merger or consolidation, and the mode of carrying the same into effect, as well as the manner and basis of converting the shares of the constituent corporations into the shares of the consolidated or surviving corporation. The agreement may

also provide for the distribution of cash, property, or securities, in whole or in part, in lieu of shares, to shareholders of the constituent corporations or any class of them; provided, however, that upon such distribution of cash, property or securities, the liabilities of the consolidated or surviving corporation, including those derived by it from the constituent corporations, plus the amount of the stated capital of the consolidated or surviving corporation, shall not exceed the value of the assets of such consolidated or surviving corporation.

If the agreement is for a consolidation, it shall state the matters required to be stated in articles of incorporation and these statements shall be deemed to be the articles of the new or consolidated corporation.

If the agreement be for a merger, it shall state any matters with respect to which the articles of the surviving corporation are amended, and the articles shall be deemed to be amended accordingly upon the filing thereof with the secretary of state.

(2) The agreement shall be signed by the president or a vice-president and the secretary or an assistant secretary of each corporation, and acknowledged by the officers executing the same on behalf of their respective corporations.

(3) The agreement must be approved by the vote of the holders of not less than two-thirds of the issued and outstanding shares of each class, even though their right to vote be otherwise restricted or denied, of each of the constituent corporations, at a meeting duly called upon notice of the time, place and purpose thereof, duly given to each shareholder at least twenty days prior to the date

of such meeting. There shall be mailed with the notice of such meeting a statement of the general terms of the proposed agreement. Different series of the same class of shares shall not be construed to constitute different classes of shares for the purposes of voting by classes.

The approval of the shareholders may be given either before or after the approval of the agreement by the board of directors.

After such approval by the directors and shareholders has been given, the president or a vice president and the secretary or an assistant secretary of each corporation shall execute a certificate, which shall be verified by their oath and shall set forth:

(a) The time and place of the meeting of the board of directors;

(b) A copy of the resolution adopted thereat;

(c) The vote in favor of such resolution;

(d) The time and place of the meeting of the shareholders, and the total vote of each class of shares by which the agreement was approved;

(e) The total number of outstanding shares of each class;

(f) A statement of the mailing of the notice of the time, place and purpose of the meeting of the shareholders.

(4) Any amendment to the agreement may be adopted, and the agreement so amended may be approved, by like vote at such meeting of any of the constituent corporations, and if the agreement so amended be approved by like vote at such meeting and by the board of directors of each of the constituent corporations, the agreement so

amended shall be signed and acknowledged and shall have certified therewith the approval of the directors and of the shareholders in the same manner as provided for the original agreement, and shall then be considered the merging or consolidating agreement.

(5) The agreement so approved, executed and acknowledged and the certificates of its approval shall be filed with the secretary of state, and shall thereupon become effective, and the several parties thereto shall be one corporation. A copy of said agreement, certified by the secretary of state, shall be filed with the county clerks of the counties in which the principal office of each corporation is located and a copy of said agreement so certified shall be filed in the office of the county clerk of each county in which each corporation holds real property. A copy of such agreement or of a certified copy thereof certified by any official having custody thereof shall have the same force in evidence as the original, and, except as against the State, shall be conclusive evidence of the performance of all conditions precedent to such consolidation or merger, and the creation or existence of the consolidated or surviving corporation.

(6)The surplus appearing on the books of the constituent corporations, to the extent to which it is not capitalized by the issue of shares or otherwise, may be entered as earned or paid-in surplus, as the case may be, on the books of the consolidated or surviving corporation, and may thereafter be dealt with as such.

(7) Upon the merger or consolidation, as provided herein, the separate existence of the constituent corporations shall cease, except that of the surviving corporation in case of merger, and the consolidated or surviving

corporation shall succeed, without other transfer, to all the rights and property of each of the constituent corporations, and shall be subject to all the debts and liabilities of each, in the same manner as if the surviving or consolidated corporation had itself incurred them.

All rights of creditors and all liens upon the property of each of said former corporations shall be preserved unimpaired, limited in lien to the property affected by such liens immediately prior to the time of the consolidation or merger.

Any action or proceeding pending by or against any of such constituent corporations may be prosecuted to judgment, which shall bind the consolidated or the surviving corporation, or the consolidated or surviving corporation may be proceeded against or substituted in their place.

The directors of the corporation may, in their discretion, abandon such merger or consolidation subject to the rights of third parties under any contracts relating thereto, without further action or approval by the shareholders of the corporation, at any time before the merger or consolidation has been completed.—1933:1358."